Internal Revenue Service
memorandum

CC:WR:RMD:SLC:TL-N-7121-98
RWKennedy

date: APR 2 3 1999

to: District TEFRA Coordinator
Rocky Mountain District

from: District Counsel, Salt Lake City
Western Region

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subject: Advisory Opinion
Entity and TEFRA Determination

This is in response to your memorandum dated October 5, 1998, in which you requested advice on the type of entity in which the taxpayer is doing business and a determination as to whether the entity is subject to TEFRA procedures.

Under the circumstances outlined in your memorandum, we conclude:

1) you should treat [redacted] as a general partnership with one partner and issue an FPAA to [redacted];

2) you should treat [redacted] as a trust and issue a notice of deficiency to [redacted]; and

3) you should open individual cases on the two individuals and issue a notice of deficiency to each of them.

These conclusions--and our recommendations in regard to the [redacted] situation--are explained in more detail below.

FACTS

The facts on which we rely in giving this opinion are as follows:

1. This case involves three tiers: the first, [redacted] (hereinafter [redacted]), generates business income from an unidentified business; the second, [redacted] (hereinafter [redacted]) receives income from [redacted] and passes it through to the third tier; the third tier apparently consists of two individuals, [redacted] and [redacted].

2. The first tier you discuss, [redacted], filed a Form 1065 U.S. Partnership income tax return for the taxable year ended December 31, [redacted], on [redacted]. [redacted] is a domestic LLC under the Arizona LLC statutes. The address for [redacted] is [redacted].

3. Included with [redacted]'s [redacted] return was a Schedule K-1 designating [redacted] as the 100% partner of the LLC.

4. The questions on Schedule B of [redacted]'s [redacted] return were answered as follows:

> Question 1--type of entity: [space left blank]
> Question 4--is this a TEFRA entity: [Answer: No]
> Designation of TMP: [no TMP designated]

5. [redacted]'s [redacted] return is signed "All rights reserved [redacted] [illegible title]". The return discloses $[redacted] in gross receipts, which is ultimately reduced to $[redacted] in taxable income, and does not describe the nature of the trade or business.

6. The prior-year return (for [redacted]) evidences the same pattern, except that Schedule B, Question 1, "type of entity", indicates that the entity is a General Partnership.

7. Apparently, [redacted] has never made a "check the box" election by filing a Form 8832.

8. The second tier, [redacted], the LLC's sole partner, filed a Form 1041 for its [redacted] taxable year on [redacted], designating itself as a simple trust. It is believed to be signed by [redacted]. The address for [redacted] is [redacted], which is an address associated with [redacted].

9. The [redacted] [redacted] return shows income of $[redacted] and flows it through to [redacted]% beneficiaries, [redacted] and [redacted], both of whom are nonfilers. A substitute for return has been prepared for [redacted], but none has yet been prepared for [redacted]. Both [redacted] and [redacted] have a history of nonfiling and of making spurious arguments relating to taxation.

10. [redacted] has recently submitted a Form 2848 designating two individuals with [redacted] in [redacted], as POAs. The individuals are [redacted] and [redacted]. The Form has been returned, since it has been improperly prepared. However, the form is signed "[redacted] Tax Matters Director."

11. [redacted] ([redacted]) is an abusive trust promotion [redacted].

LEGAL ANALYSIS--[redacted]

Your first set of questions involves the classification of [redacted] and whether it is subject to TEFRA audit procedures.

The answer to that is that [redacted] is clearly subject to TEFRA procedures; however, this does not necessarily mean that adjustments to the other tiers will require normal TEFRA treatment. In fact, we recommend that you treat the adjustments to [redacted] as partnership adjustments to [redacted] but as NON-partnership adjustments to the partners' returns (and thereafter follow the notice of deficiency procedures, rather than merely considering these adjustments automatic, flow-through adjustments from the TEFRA entity). We will discuss both of these recommendations below, starting with the TEFRA recommendation. As explained in more detail below, the Service may convert a partner's partnership items to non-partnership items and thereby that partner will become subject to deficiency notice procedures. However, we must start with the TEFRA procedure--in this sense, TEFRA is not optional--it is mandatory until the Service affirmatively acts to take the particular adjustments out of the "partnership adjustment" category.

TEFRA RECOMMENDATION: [redacted] is an Arizona LLC. In Rev. Rul. 93-93, 1993-2 C.B. 321, the Service concluded that "[b]ecause of the flexibility accorded by the Arizona Limited Liability Company Act, an Arizona limited liability company may be classified as a partnership or as an association taxable as a corporation depending upon the provisions adopted in the limited liability company's articles of organization or operating agreement."

[redacted] classified itself as a general partnership on its [redacted] federal partnership return. The [redacted] return made no entries on its Schedule B which would indicate that the partnership classification should be changed. The Service apparently has no information showing that [redacted] should be classified as a corporation. Consequently, you may properly leave the classification unchanged and treat [redacted] as a partnership for the [redacted] taxable year.[1] (This suggestion is subject to

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[1] We note that this conclusion is in accordance with the intent of the new "check the box" regulations, effective in 1997,

change, of course, if you find facts indicating corporate status, as you develop the case. In the event that such facts surface, please contact District Counsel for further advice.) See, also, Consolidated Cable v. Commissioner (I), T.C. Memo. 1990-657, affirmed in part reversed in part, unpublished op. (5th Cir. No. 92-4856, 6/3/93), which held that since a partnership return was filed, TEFRA applies regardless of whether entity was actually a partnership because of § 6233.

Assuming, arguendo, that [redacted] may properly be treated as a general partnership, we will next discuss your TEFRA questions as to [redacted].

I.R.C. § 6621 states that, "[e]xcept as otherwise provided in this subchapter, the tax treatment of any partnership item shall be determined at the partnership level."

I.R.C. § 6031(a)(1)(A), as in effect for taxable year [redacted], defined the term "partnership" as "any partnership required to file a return under section 6031(a)." However, there was an exception for small partnerships stating that the term "partnership" shall not include any partnership if--

> (I) such partnership has 10 or fewer partners each of whom is a natural person (other than a nonresident alien) or an estate, and
>
> (II) each partner's share of each partnership item is the same as his share of every other item.

(For purposes of the exception, a husband and wife (and their estates) shall be treated as 1 partner. Any such small partnership may for any taxable year elect to be treated as a TEFRA partnership; however, no elections were made in this case.)

Since the only partner of [redacted] was [redacted], a trust, and since trusts are not listed as an allowable partner under the exception, then the small partnership exception would not apply to [redacted]. Thus, it would be proper to follow the TEFRA procedures for any [redacted] adjustments (this includes sending an NBAP to the TMP, as well as an FPAA). See, R.F. Ivory, DC Ohio, 96-1 USTC P50,078, which held that the small partnership exception did not apply because one partner was a trust. The fact that the trust was a revocable living trust subjecting the grantor, an individual, to potential income tax liability did not cause the trust to cease to exist for purposes

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which default entities to partnership or sole proprietorship status and do not impose corporate status unless an entity has been chartered as such under state or federal law.

of the rule limiting the small partnership exception to partnerships with only natural persons as partners. See, also, Primco v. Commissioner, T.C. Memo. 1997-332, which held that the small partnership exception did not apply because one partner was a grantor trust. The fact that the trust was not recognized for other purposes of subtitle A did not matter.

The next question is who would be considered the TMP. Although the exact facts are somewhat fuzzy in this case, it appears that no Tax Matters Partner has been designated by [redacted]. In the absence of a designation by the partnership, the general partner (member manager for an LLC, § 301.6231(a)(7)-(2)) with the largest profits interest is the TMP by operation of law. In our case, this means that [redacted] is the TMP, it being the general partner with the greatest (the only) profits interest. I.R.C. § 6031(a)(7)(B). However, the question of who is the TMP will, we suspect, be essentially irrelevant in the final resolution of this case, because 1) it is unlikely that you will get any cooperation from whoever is the TMP and 2) we think that you should, in any event, send duplicate originals of both the NBAP and FPAA, thus mooting the problem. These duplicate originals would be, first, a "generic" notice addressed to "[redacted], Tax Matters Partner" and, second, a specific notice addressed to "[redacted], Tax Matters Partner". See, Seneca v. Commissioner, 92 T.C. 363 (1989), affirmed without published op. 899 F.2d 1225 (9th Cir. 1990) and Wayne Caldwell Escrow Partnership, 72 TCM 554, Dec. 51,532(M), TC Memo. 1996-401, both of which held essentially that a generic FPAA that was mailed to "Tax Matters Partner" at the partnership's address met the requirement that a partnership's tax matters partner be sent a notice of FPAA with respect to adjustments to partnership items. It was not necessary that the IRS know the identity of the TMP or appoint one, so long as the partners received notice.

We now turn to the question of what the result would be of the issuance of an FPAA to [redacted]. Normally, the resulting adjustment to the (partnership items of) taxable income of the second tier, [redacted], would be nothing more than a mathematical adjustment based upon the results of the computation in the first tier, and therefore, TEFRA treatment would be appropriate for that tier. See, Sente Investment v. Commissioner (II), 95 T.C. 243 (1990) which held that indirect partners, i.e. partners of a tier partnership, are bound by determinations at the source partnership level and subject to computational adjustments; Regan v. Commissioner, T.C. Memo 1993-623, which held that when the source is a TEFRA partnership, and the flow-through partnership is non-TEFRA (a tiered partnership), the flow-through items are partnership items subject to TEFRA procedures; disallowance of penalties must await outcome of partnership proceeding; and N.C.F. Energy v. Commissioner, 89

T.C. 741 (1987), holding that computational assessment of affected items not requiring partner level determinations are made without issuance of notice.

Further, under the provisions of I.R.C. § 6231(a)(2)(B), the term "partner" means not only a partner in the partnership, but also any other person whose income tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership. Thus, the individuals would also be considered a "partner" of [redacted], by virtue of their pass-through interest in [redacted]. Normally, under the TEFRA unified partnership audit procedures, the issuance (and later resolution) of the FPAA would result in an automatic adjustment being made to the income of the lower tiers, without the necessity of the issuance of a notice of deficiency.[2] However, in this case, we do not think that the normal result (i.e., the automatic adjustment) will apply or should be used. Rather, we suggest that you convert the partnership items to non-partnership for [redacted] and the individuals, as set out below. Which leads us to the discussion of our "non-partnership adjustment recommendation" as to [redacted] and the individuals.

NON-PARTNERSHIP ADJUSTMENT RECOMMENDATION (USE OF INDIRECT METHOD OF PROOF): Using the "non-partnership recommendation", means that we think that you should issue an FPAA to [redacted] with adjustments to the partnership items of [redacted], but, inconsistently, issue a statutory notice to the trust and the individuals treating those adjustments as NON-partnership adjustments.

When the unified partnership procedures were first proposed, it was recognized that there were certain areas in the field of taxation that would not readily lend themselves to the TEFRA rules. I.R.C. § 6231(c) provides that, insofar as the Service determines that to treat certain items as partnership items would

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[2] Please note that using this "TEFRA recommendation" would not normally result in the typical "whipsaw" of tax between [redacted] and the individuals, since [redacted], as a partnership, will have no separate income tax liability (employment taxes are another matter). Rather, the entire taxable income of the partnership would normally be passed through to [redacted]. (Of course, if [redacted] does not cooperate in the audit, the $[redacted] in gross receipts may be accepted and the claimed expenses disallowed, which will ultimately increase [redacted]'s income substantially from the reported $[redacted].)

interfere with the effective and efficient enforcement of the internal revenue laws, these items can be designated as "non-partnership items". Although there is no specific regulation exempting tiered arrangements involving trusts from the TEFRA procedural rules, we do think that there are certain exceptions in the law which will frequently apply in such cases. For example, I.R.C. §§ 6231(c)(1)(C), pertaining to indirect methods of proof and, potentially, 6231(c)(1)(E), pertaining to other areas subject to special enforcement considerations, may be applicable to the trust area.

In this case, it appears that the provisions of I.R.C. § 6231(c)(1)(C) would apply. That section provides, in pertinent part, as follows:

> (c) Regulations with respect to certain special enforcement areas.--
>
> (1) Applicability of subsection.--This subsection applies in the case of--
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> * * * *
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> (C) indirect methods of proof of income,
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> * * * *
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> (2) Items may be treated as nonpartnership items.--To the extent that the Secretary determines and provides by regulations that to treat items as partnership items will interfere with the effective and efficient enforcement of this title in any case described in paragraph (1), such items shall be treated as nonpartnership items for purposes of this subchapter.

Treas. Regs. § 301.6231(c)-6 provides as follows:

> Sec. 301.6231(c)-6 Indirect method of proof of income.
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> The treatment of items as partnership items with respect to a partner whose taxable income is determined by use of an indirect method of proof of income will interfere with the effective and efficient enforcement of the internal revenue laws. Accordingly, partnership items of such a partner arising in any partnership taxable year ending on or before the last day of the taxable year of the partner for which a deficiency notice based upon an indirect method of proof of income is mailed to the partner shall be treated as nonpartnership items as of the date on which that deficiency notice is mailed to the partner.

We have three tiers in this case: the first, [redacted], generates business income from an unidentified business; the second, [redacted], receives income from [redacted] and passes it through to the third tier; the third tier apparently consists of two individuals, [redacted] and [redacted].

The question then becomes whether the present factual situation with the three tiers falls within the regulatory language of Treas. Regs. § 301.6231(c)-6 providing for the non-partnership treatment of items normally considered as partnership items with respect to a partner whose taxable income is determined by use of an indirect method of proof. [emphasis added]. The problem, of course, is that under a literal reading of the regulation, the "partner" is the second tier, [redacted], rather than either [redacted] or the [redacted]. In our opinion, the regulation applies in your factual situation, as set out below.

What the Service ultimately wishes to do in this set of cases is to determine the proper taxable income and tax liability for the entities and individuals, give them notice of this liability, and collect against them. Since the major problem in this case, as discussed below, is in tying the individual non-filers to a source of income, the Service clearly has NO direct proof of income--we cannot even ask their employer, since we do not know if they even have an employer. All proof which the Service is likely to find will be of an indirect type.

At present, the Service has LLC/trust returns without information regarding the type of business in which the individuals are engaged, or its location. However, the return of [redacted] shows a substantial gross income, essentially all of which is wiped out by claimed business deductions or the income distribution deduction. [redacted] (b)(7)a (b)(7)a (b)(7)a. It is, therefore, likely that the Service will be forced to use information from third-party sources both to confirm the accuracy of the amount of gross income shown on [redacted]'s returns and to obtain information regarding the expenses shown (which is necessary to a determination of the correct taxable income).

Any proof of income and expenses which the Service is likely to find will be of an indirect type, such as what is shown by a bank deposits analysis, standard of living analysis, net worth determination, etc.

This is particularly true in regard to the individuals, since [redacted] and [redacted] did not file income tax

returns for the [redacted] taxable year, since they have a history of nonfiling, and since they have a history of making spurious arguments in regard to their tax liabilities. It is likely that they will not now file proper income tax returns for that year of their own accord. The fact that they did not file any returns means that the Service has no information on their income and will have to develop this information from other sources. Their participation in an abusive trust scheme, and representation by other participants in abusive trust schemes, indicates that the Service will have to rely upon an indirect method of proof of both their gross income and their net income. Thus, the ultimate taxpayers in this case (i.e., [redacted] and [redacted]) are also clearly individuals whose taxable income will also have to be determined by an indirect method.[3]

OTHER MATTERS REGARDING [redacted]: It should be noted that we have not discussed a threshold question regarding [redacted]--the question of whether the LLC can actually be treated as a "partnership" at all--because our advice would not change whether the LLC is theoretically a "partnership" or theoretically some other type of entity.

I.R.C. §761(a) provides in pertinent part that, "[f]or purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this subtitle, a corporation or a trust or estate."

It is clear that there can be no "partnership" unless there are at least two partners--i.e., there must be some sort of "joint" business venture, and this means that there must be at least two parties, acting together.[4]

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[3] We note that there are certain other requirements to be met to convert the partnership items of [redacted] to non-partnership items for [redacted] and the individuals, see, e.g., Treas. Reg. §301.6231(c)-3, but it appears that this case meets all of them. Therefore, this case can be handled under the exception to the TEFRA rules set out above.

[4] In pertinent part, the Uniform Partnership Act, §3, provides: "Partnership defined. A partnership is an association of two or more persons ... ." The Uniform Partnership Act has been adopted in all American states and territories except Louisiana and Puerto Rico.

If [redacted] is not a partnership, then under ordinary rules of logic, presumably the partnership audit provisions would not apply and the audit of [redacted] should presumably be concluded with the issuance of a statutory notice of deficiency. However, the TEFRA rules do not follow this ordinary logic. Rather, even if [redacted] were not actually a partnership, the fact remains that it filed a partnership return for its [redacted] taxable year and identified itself as a General Partnership and also filed a partnership return for its [redacted] taxable year. Under the provisions of I.R.C. § 6233(a) and Treas. Reg. §, "[i]f a partnership return is filed by an entity for a taxable year but it is determined that the entity is not a partnership for such year, then" the TEFRA procedural provisions are extended "for such year to such entity and its items and to persons holding an interest in such entity." Thus, whether or not it is in actuality a "partnership", it is treated as if it were, simply by virtue of its filing a partnership return. This result, of course, leads us back to our original discussion and our ultimate conclusion that notice of deficiency procedures should be used.

A similar question arises in conjunction with state LLC statutes--can an LLC exist if it has only one "member"? Some states have provided statutory guidance on this point. For example, Arkansas specifically provides that LLCs with one member are to be treated as sole proprietorships and LLCs with more than one member are to be treated as partnerships. Arkansas Code Ann. §§ 4-32-1313, 26-51-802. Colorado, on the other hand, allows LLCs of one or more natural persons, but requires all LLCs to file a partnerships tax return and treats them as conduits for state tax purposes. Colo. Rev. Stat. §§ 7-80-203. [redacted] is ostensibly an Arizona LLC, even though operating in Colorado. Arizona requires that an LLC have two or more members at the time the LLC was formed. Ariz. Stat. Ann. §29-632. However, A.S.A. §29-781(A)(3) permits continuation of the LLC by one member or manager. Although we do not know whether [redacted] was validly formed under the Arizona statute, it does appear that it can continue with only one member. Again, however, state law considerations are some what irrelevant, in view of the provisions of I.R.C. § 6233, and do not change our suggested course of action.

LEGAL ANALYSIS--[redacted]

One of your questions was how to handle the audit of [redacted]. Fortunately, [redacted] filed a Form 1041 trust return for [redacted], so there is no TEFRA problem in regard to it, as such.

However, as stated above, the adjustments to [redacted]'s return are clearly "partnership adjustments" under I.R.C. § 6231(a)(1(3) since the income and deductions of that entity are more appropriately determined at the partnership level. According to Maxwell v. Commissioner, 87 T.C. 783 (1986), a unanimous, reviewed opinion, the Congressional intent of TEFRA partnership provisions was to create separate administrative and judicial procedures for resolutions of taxpayers' partnership items and non-partnership items. Thus, the pass-through adjustments to [redacted] would be automatic adjustments and the Service would have to wait until the TEFRA proceeding was concluded and then assess and collect against the partner ([redacted]) as a mathematical adjustment.

Nevertheless, the rationale set out in detail above regarding the indirect method of proof applies to [redacted]. Even though the Service has a return showing pass-through income from [redacted], it will have to examine the books and records of [redacted] and the back-up material found in [redacted]'s financial accounts to determine the correct income of [redacted]. The Service will also have to examine any other accounts which it may be able to find for [redacted], itself. Thus, [redacted]'s taxable income will likely also have to be determined by an indirect method.

The result of this is that the Service should take what is, in essence, a whipsaw position in regard to the partnership adjustments of [redacted] in order to treat this income as a non-partnership adjustment to [redacted]'s return and issue a statutory notice of deficiency to [redacted].

LEGAL ANALYSIS--INDIVIDUALS

(b)(5)(AC) [redacted]

(b)(7)a [redacted]

(b)(7)a

(b)(7)a
(b)(7)a

In summary, you should issue statutory notices of deficiency to the individuals, including the [redacted] adjustments in their statutory notices as non-partnership adjustments, and also including any other adjustments which you may find.

OTHER CONSIDERATIONS

There is also a coordination problem which must be addressed in this case. We understand that the Ogden Service Center TEFRA unit handles the final processing and issuance of the FPAA, not the Revenue Agent or the Rocky Mountain District. On the other hand, under the procedures outlined in this memo, the District will be issuing the notices of deficiency to the trust and the individuals. Consequently, EACH of the files must be clearly marked to show the names and EIN/SSNs or each of the related cases. That way, when the cases come to Counsel, the entire package may be consolidated for trial.

The use of the non-partnership adjustment recommendation for [redacted] and the individuals will have certain advantages similar to the whipsaw notices used in typical trust schemes. After the FPAA for [redacted] and the statutory notices for [redacted] and the individuals are issued, Counsel can request the Tax Court to consolidate the cases for trial, thus achieving the same efficiency as would exist in the case of inconsistent statutory notices. If, on the other hand, one of the cases defaults, the Service can immediately assess and begin collection activities.

CONCLUSIONS

Under the circumstances outlined in your memorandum, we conclude:

1) you should treat the income and expenses of [redacted] as partnership items and issue an FPAA to [redacted];

2) you should treat [redacted] as a trust and issue a notice of deficiency to it (any income from [redacted] based on indirect methods of proof should be added to [redacted]'s income in the statutory notice, even though such adjustments would normally be treated as and are also in this case automatic flow-through TEFRA adjustments from the [redacted] FPAA, above); and

3) you should open individual cases on the two individuals and two notices of deficiency should be issued (again, any income from [redacted] based on indirect methods of proof should be added to the individuals' income in the statutory notices, even though such adjustments would normally be treated as and are also in this case automatic flow-through TEFRA adjustments from the [redacted] FPAA, above).

If you have any questions, please call Richard W. Kennedy of this office at (801) 799-6633. Inasmuch as nothing further needs to be done in this case at this time, we are closing our file.

Richard W. Kennedy
Attorney